DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0064
Gross Retail Tax
For the Years 1998 and 1999

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ISSUES

I. Construction Contracts – Gross Retail Tax.

Authority: IC 6-2.5-1-1; IC 6-2.5-1-2; IC 6-2.5-2-1(a); IC 6-2.5-4-1(b); IC 6-2.5-4-1(e); Cowden & Sons Trucking, Inc. v. Indiana Dept. of State Revenue, 575 N.E.2d 718 (Ind. Tax Ct. 1991); 45 IAC 2.2-3-7; 45 IAC 2.2-3-7(a); 45 IAC 2.2-3-7(b); 45 IAC 2.2-3-8(b); 45 IAC 2.2-3-12(e).

Taxpayer challenges the decision by the Department of Revenue (Department) resulting in an assessment of uncollected gross retail (sales) tax on the proceeds received from certain construction and installation contracts.

II. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer requests that the Department exercise its discretion to abate entirely the ten-percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is a carpenter/contractor. Taxpayer builds items such as kitchen cabinets, entertainment centers, and bookcases and sells those completed items to customers. Taxpayer also enters into agreements for the construction and installation of items in which some of the construction work is completed off-site, and some of the work is completed at the customer's own location.

The Department conducted an audit of taxpayer's business and tax records. On the basis of that audit review, the Department concluded that taxpayer was entering into "unitary contracts" for which sales tax should have been collected on the total amount. Having failed to do so, the Department assessed taxpayer an amount for the uncollected sales tax.

Taxpayer disagreed with the audit's conclusions and submitted a protest to that effect. An administrative hearing was conducted, taxpayer explained the basis for his protest, and this Letter of Findings results.

DISCUSSION

I. Construction Contracts – Gross Retail Tax.

Pursuant to IC 6-2.5-2-1(a), Indiana imposes a sales tax on all retail transactions made in this state. IC 6-2.5-4-1(b) defines a "retail transaction" as the acquisition of tangible personal property by a retail merchant for the purpose of resale and subsequent transfer of that property to another for consideration. A retail transaction is defined as "selling at retail." "Selling at retail" is defined in IC 6-2.5-4-1(b).

> A person is engaged in selling at retail when, in the ordinary course of his regularly conducted trade or business, he: (1) acquires tangible personal property for the purpose of resale; and (2) transfers that property to another person for consideration.

Since the sales and use tax statutes specifically state that the transfer of tangible personal property is taxable, by implication the transfer of services is not taxable. Except for certain enumerated services, the provision of services is not considered a "retail transaction" and the cost of such services is not subject to sales tax.

There are two instances in which the otherwise nontaxable sale of a service is subject to sales tax. The first is when the services are performed with respect to tangible personal property being transferred in a retail transaction, and the services take place before the transfer of the tangible personal property. IC 6-2.5-4-1(e) states that "[t]he gross retail income received from selling at retail is only taxable . . . to the extent that the income represents: (1) the price of the property transferred, without the rendition of any service: and (2) . . . any bona fide charges which are made for preparation, fabrication, alteration, modification, finishing, completion, delivery or *other service performed in respect to the property transferred before its transfer* and which are separately stated on the transferor's records." For example, the entire purchase price of an automobile is subject to sales tax even though the total price includes both the cost of materials (steel, nuts, bolts, glass) and the cost of services (labor, delivery charges) because the automobile manufacturer's services are all performed up-stream of the retail transaction.

The second exception is when the cost of services is part of a "unitary transaction." IC 6-2.5-1-2. A "unitary transaction" is defined as a transaction that includes the transfer of tangible personal property and provision of services for a single charge pursuant to a single agreement or order. IC 6-2.5-1-1. For example, if a customer hires a vendor to install telephone equipment in the customer's office and the vendor – having completed the installation work – presents a bill for $500, the entire $500 is subject to sales tax. The parties' agreement to install the telephone equipment constitutes a "unitary transaction" even though the parties intended the agreement to cover both the installation work and the telephones. However, in Cowden & Sons Trucking, Inc. v. Indiana Dept. of State Revenue, 575 N.E.2d 718, 722 (Ind. Tax Ct. 1991), the Tax Court stated that "the legislature intends to tax services rendered in retail unitary transactions only if the transfer of property and the rendition of services is inextricable and indivisible."

A. Unitary Transactions:

Therefore, when taxpayer sells a customer an item such a custom-built furniture or a completed kitchen countertop, the taxpayer is engaged in a unitary transaction, and the entire cost is subject to sales tax. Any service or labor costs which are attributable to the cost of the furniture or the countertop were incurred before the item was transferred to the customer. The customer is purchasing a completed item – the furniture or the countertop – which has a unique and indivisible value to that customer. In such a transaction, the taxpayer is acting as a retail merchant, is engaged in a retail transaction, and must collect sales tax on the total price of the item. The fact that taxpayer may present the customer a bill which separately states the cost of the labor and the materials expended in building the furniture or the countertop is irrelevant. There is no indication that the taxpayer and his customers – in this category of transactions – bargain for the service or labor costs. Rather, these transactions are similar to the purchase of an automobile. The fact that the auto manufacturer presents a bill which states separately the cost of the raw materials and the upstream labor costs would be equally irrelevant because the car customer and the car dealer have entered into a unitary transaction. The car dealer must collect sales tax on the entire cost of the vehicle even if much of that cost is attributable to labor.

Each transfer of a completed, ready-to-install cabinet – from taxpayer's workshop to the customer's location – constitutes an up-front, severable "unitary transaction" consisting of both the initial labor costs in building the cabinet and the materials used to build those cabinets. Taxpayer must charge sales tax on the both the labor expended and the material acquired up to the time that taxpayer completes construction and delivery of the cabinets because the transfer of each completed, ready-to-install unit constitutes a unitary transaction. Taxpayer must collect sales tax on the entire cost of each cabinet, entertainment center, or any other completed item he constructs for one of his customers.

B. Construction Contracts:

However, taxpayer also performs on-site carpentry work for customers. In these types of transactions, taxpayer brings raw, unfinished materials – wood, nails, finishing lumber – to a customer's location and completes the work at that location. Taxpayer provides the raw materials, performs the work at the customer's location, and presents a bill which distinguishes between the cost of the installed materials and the cost of the labor. Under these circumstances, taxpayer is not acting as a "retail merchant" but falls within the definition of a "contractor." 45 IAC 2.2-3-7(a) states that, "For purposes of this regulation . . . 'contractor' means any person engaged in converting construction materials into realty. The term 'contractor' refers to general or prime contractors, subcontractors, and specialty contractors including . . . . persons engaged in building, cement work, carpentry, plumbing, heating, electrical work, roofing, wrecking, excavating, plastering, tile and road construction."

The raw materials taxpayer brings to the construction site – the wood, fasteners, paint – fall within the definition of "construction materials" as defined under 45 IAC 2.2-3-7 because the materials constitute "tangible personal property . . . used for incorporation in or improvement of a facility or structure constituting or becoming part of the land on which such facility or structure is situated." 45 IAC 2.2-3-7(b).

The cost of these construction materials is subject to sales tax. "All construction material purchased by a contractor is taxable either at the time of purchase, or if purchased exempt (or otherwise acquired exempt) upon disposition unless the ultimate recipient could have purchased it exempt." 45 IAC 2.2-3-8(b). Therefore, unless taxpayer's customer is itself – exempt – a church or otherwise legitimately exempt organization – taxpayer must collect sales tax on the raw materials he brings to and incorporates into the customer's building. Assuming he did not pay sales tax at the time he acquired the raw materials, taxpayer must collect sales tax on the baseboard he fastens to a customer's walls; taxpayer must collect sales tax on the glue he uses to fasten a countertop to a customer's kitchen cabinets; taxpayer must collect sales tax on the fasteners he uses to install the treads on a customer's stairway. However, in these instances, taxpayer is not necessarily required to collect sales tax on the labor involved. 45 IAC 2.2-3-12(e) states that, "A person selling tangible personal property to be used as an improvement to real estate may enter into a completely separate contract to furnish the labor to install or construct such improvement, in which case the sales tax shall be collected and remitted by such seller on the materials sold for this purpose. Such sale of materials must be identifiable as a separate transaction from the contract for labor." Therefore, if taxpayer – at the time of the transaction – furnishes a bill for the cost of the materials incorporated into the customer's realty and separately states on that bill the cost of the related labor, taxpayer is relieved of the requirement to collect sales tax on the labor portion of the bill. However, taxpayer is cautioned that under these circumstances, "The fact that the seller subsequently furnishe[s] information regarding the charges for labor and material under a flat bid quotation shall not be considered to constitute separate transactions for labor and material." 45 IAC 2.2-3-12(e).

In sum, the audit report correctly determined that taxpayer was responsible for collecting sales tax on each unitary transaction and that taxpayer was responsible for collecting sales tax on the material portion of construction contracts.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer asks the Department to exercise its discretion and abate the ten-percent negligence penalty.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer

must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

The Department agrees with taxpayer that the positions it took in regard to its Indiana sales tax liabilities – however erroneous – were indicative of "reasonable cause and not due to willful neglect."

FINDING

Taxpayer's protest is sustained.

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